

2023 Supplemental Problem Solution

The following problem will take the user through the lifecycle of J & L Custom Cakes, LLC. John and Lisa were two competing specialty cake shops located in Milwaukee, WI. They determined they could be more profitable if they joined forces and became partners rather than competitors. They formed an LLC in which to operate their business. In addition, they wish to be taxed as a partnership. Based upon the assets and cash they have to contribute; John will own $\frac{1}{3}$ of the LLC and Lisa will own $\frac{2}{3}$.

The situations which follow require various computations to determine basis and ownership of the LLC at different times during the lifecycle. Tables have been included to assist you in these calculations.

SITUATION 1. J & L CUSTOM CAKES, LLC FORMATION, JANUARY 1, 20x1

J & L Custom Cakes, LLC was formed January 1, 20x1 when John and Lisa contributed their respective assets to the new business organization. Following are the basis and FMV figures for their respective contributions. In addition to the contributions shown on the depreciation schedule below, the members also made these contributions.

Assets of John	FMV	Assets of Lisa	FMV
Mixer	\$ 1,300	Oven	\$ 1,500
Cash register	400	Stove	600
Display case	600	Computer	1,000
Goodwill	40,000	Printer	500
Cash	3,700	Office furnishings	1,000
200 Shares ABC Corp (Stock basis \$1,000)	4,000	Delivery van	13,000
Total assets	\$50,000	Kitchen equipment	2,000
		Building	198,000
		Land	11,500
		Goodwill	5,000
		Cash	300
		Accounts receivable	15,000
		Bakery supplies	600
		Total assets	\$250,000
		Mortgage on building	(150,000)
		Net contribution	\$100,000

20x0 Depreciation Schedule

Assets of John	Acquisition Date	Cost	§179	Basis	Life	Method	Prior	Remaining Basis
Mixer	01/02/15	\$1,500		\$1,500	7	MACRS	\$ 214	\$1,286
Cash register	01/02/15	600		600	7	MACRS	86	514
Display case	01/02/11	800		800	7	MACRS	115	685
Goodwill	01/01/14	5,000		5,000	15	SL	500	4,500
Total assets		\$7,900		\$7,900			\$915	\$6,985

Assets of Lisa	Acquisition Date	Cost	§179	Basis	Life	Method	Prior	Remaining Basis
Building	06/19/07	\$185,000		\$185,000	39	MACRS	\$40,521	\$144,479
Lot	06/16/07	5,000		5,000		ND	0	5,000
Oven	07/23/14	2,800		2,800	7	MACRS	1,086	1,714
Stove	07/23/14	1,000		1,000	7	MACRS	388	612
Computer	11/30/15	1,500		1,500	5	MACRS	225	1,275
Printer	11/30/15	600		600	5	MACRS	120	480
Office furnishings	02/01/15	2,000		2,000	7	MACRS	286	1,714
Delivery van	11/30/15	15,000	3,260	11,740	5	MACRS	0	11,740
Kitchen equipment	07/01/08	4,000		4,000	7	MACRS	4,000	0
Goodwill		0		0			0	0
Total assets		\$216,900		\$213,640			\$46,626	\$167,014

Complete Table A to show the initial contributions of John and Lisa, their bases and capital account calculations at the time of contribution on January 1, 20x1.

Situation 1, Table A
J & L Custom Cakes, LLC
Contributions on January 1, 20x1

John	Basis	FMV
Cash	\$ 3,700	\$ 3,700
Accounts receivable	0	0
Bakery supplies	0	0
200 shares stock ABC Corp.	1,000	4,000
Equipment & vehicle	2,485	2,300
Building	0	0
Land	0	0
Goodwill	4,500	40,000
Total assets	\$ 11,685	\$ 50,000
Loans	0	0
Net worth or capital account	\$ 11,685	\$ 50,000
Lisa		
Cash	\$ 300	\$ 300
Accounts receivable	0	15,000
Bakery supplies	0	600
Stock ABC Corp.	0	0
Equipment & vehicle	17,535	19,600
Building	144,479	198,000
Land	5,000	11,500
Goodwill	0	5,000
Total assets	\$167,314	\$250,000
Loans	(150,000)	(150,000)
Net worth or capital account	\$ 17,314	\$100,000

Complete Table B showing the merger of the two contributors' assets and liabilities to form the LLC balance sheet.

Situation 1, Table B
Opening Balance Sheet, J & L Custom Cakes, LLC
January 1, 20x1, $\frac{1}{3}$ John - $\frac{2}{3}$ Lisa Ownership

Assets	John		Lisa		LLC	
	Basis	FMV	Basis	FMV	Basis	FMV
Cash	\$ 3,700	\$ 3,700	\$ 300	\$ 300	\$ 4,000	\$ 4,000
Accounts receivable	0	0	0	15,000	0	15,000
Bakery supplies	0	0	0	600	0	600
Stock ABC Corp.	1,000	4,000	0	0	1,000	4,000
Equipment & vehicle	2,485	2,300	17,535	19,600	20,020	21,900
Building	0	0	144,479	198,000	144,479	198,000
Land	0	0	5,000	11,500	5,000	11,500
Goodwill	4,500	40,000	0	5,000	4,500	45,000
Total assets	\$11,685	\$50,000	\$167,314	\$250,000	\$178,999	\$300,000
Liabilities and Capital						
Loans	\$ 0	\$ 0	\$150,000	\$150,000	\$150,000	\$150,000
Capital	11,685	50,000	17,314	100,000	28,999	150,000
Total liabilities and capital	\$11,685	\$50,000	\$167,314	\$250,000	\$178,999	\$300,000

Complete Table C to determine the beginning basis of the LLC interest for each member.

Situation 1, Table C
Basis Computation of Member's Interest at Formation
J & L Custom Cakes, LLC January 1, 20x1, 1/3 John – 2/3 Lisa Ownership

	John	Lisa
Basis of member's interest at beginning of the year	\$ 0	\$ 0
Add:		
1. Cash contributed	\$ 3,700	\$ 300
2. Property contributed	7,985	167,014
3. Increase in long-term notes and/or mortgage liabilities		
4. Increase in short-term notes		
5. Increase in accounts payable		
6. Salary and/or interest		
7. Ordinary income		
8. Capital gain		
9. Non-taxable receipts		
10. Excess of depletion deduction over the basis of the depletable property		
11. Member's share of liability contributed by other members ¹	50,000	0
Total	\$ 61,685	\$ 167,314
Subtract:		
12. Decrease in long-term notes and/or mortgage liabilities	\$ 0	\$ 0
13. Decrease in short-term and/or mortgage liabilities		
14. Decrease in accounts payable		
15. Non-deductible expense		
16. Draws ²		
17. Other deductions ³		
18. Liability assumed by other members contributed by this member	0	50,000
Total	\$ 0	\$ 50,000
Basis of member's interest end of year prior to the taking of any ordinary and/or capital losses	\$ 61,685	\$ 117,314
Less share of LLC's debt	(50,000)	(100,000)
Capital account (line L, Schedule K-1)	\$ 11,685	\$ 17,314

¹ Liabilities that are carried to the partnership by any of the partners.

² Draw represents all items withdrawn from the partnership including salary and interest, ordinary income, cash, and property.

³ Reduction for IRC §179 deduction.

SITUATION 2. TAX PREPARATION OF J & L CUSTOM CAKES, LLC

Lisa owns $\frac{2}{3}$ of the LLC and John owns $\frac{1}{3}$. All income and allocations are shared $\frac{2}{3}-\frac{1}{3}$, except that each member receives a guaranteed payment of \$30,000 per year. LLC assets at the start of the LLC include accounts receivable, vehicles, bakery equipment, land and buildings and some inventory. To conserve energy, the members decide to sell the oven and stove and rent new ones. The gross sales include the accounts receivable that were collected in 20x1. There are \$10,000 of accounts receivable at the end of the year and \$400 of bakery supplies. Assume the FMV of the other assets remain the same. Following is a cash flow worksheet:

Situation 2, Table A Cash Reconciliation for J & L Custom Cakes, LLC, 20x1

Cash Inflow		
Cash on hand, January 1, 20x1	\$ 4,000	
Gross sales	210,000	
Interest income	100	
Sale of oven	1,500	
Operating loan borrowed	15,000	
Sale of 100 Shares ABC Corp.	2,000	
Sale of stove	600	
Cash available	\$233,200	\$233,200
Cash Outflow		
Salaries and wages	\$ 25,000	
Guaranteed payments to members	60,000	
Equipment rent	3,500	
Interest: mortgage \$7,500 + other \$600	8,100	
Taxes	3,500	
Repairs	600	
Utilities	2,500	
Other	56,000	
Telephone system purchase on April 23, 20x1	1,800	
Principal payment: mortgage \$11,000 + other \$15,000	26,000	
LLC draws	45,000	
Cash outflow	\$232,000	(\$232,000)
Cash on hand December 31, 20x1		\$ 1,200

Tax Return Amounts

Form 1065, page 1

Gross sales	\$210,000
Gain on oven and stove	107
Operating deductions	(159,200)
Depreciation	(9,588)
	\$ 41,319

Form 1065, Other Income

Interest income	\$ 100
Gain on sale of stock	1,500
Total	\$ 1,600
IRC §179 deduction	\$ 750

20x1 Depreciation Schedule

Assets of John	Acquisition Date	Cost	§179	Basis	Life	Method	Prior	Remaining Basis	20x1 Depreciation
Mixer	01/02/15	\$1,500		\$1,500	7	MACRS	\$ 214	\$1,286	\$ 367
Cash register	01/02/15	600		600	7	MACRS	86	514	147
Display case	01/02/11	800		800	7	MACRS	115	685	196
Goodwill	01/01/14	5,000		5,000	15	SL	500	4,500	333
Total assets		\$7,900		\$7,900			\$915	\$6,985	\$1,043

Assets of Lisa	Acquisition Date	Cost	§179	Basis	Life	Method	Prior	Remaining Basis	20x1 Depreciation
Building	06/19/07	\$185,000		\$185,000	39	MACRS	\$40,521	\$144,479	\$4,743
Lot	06/16/07	5,000		5,000		ND	0	5,000	0
Oven	07/23/14	2,800		2,800	7	MACRS	1,086	1,714	245
Stove	07/23/14	1,000		1,000	7	MACRS	388	612	88
Computer	11/30/15	1,500		1,500	5	MACRS	225	1,275	480
Printer	11/30/15	600		600	5	MACRS	120	480	192
Office furnishings	02/01/15	2,000		2,000	7	MACRS	286	1,714	490
Delivery van	11/30/15	15,000	3,260	11,740	5	MACRS	0	11,740	2,157
Kitchen equipment	07/01/08	4,000		4,000	7	MACRS	4,000	0	0
Total assets		\$216,900		\$213,640			\$46,626	\$167,014	\$8,395

Assets of J & L	Acquisition Date	Cost	§179	Basis	Life	Method	Prior	Remaining Basis	20x1 Depreciation
Telephone system	4/23/06	1,800	750	1,050	7	MACRS	0	1,050	150
Grand Total		\$226,600		\$222,590			\$47,541	\$175,049	\$9,588

Complete the balance sheet for December 31.

Situation 2, Table B
Ending Balance Sheet December 31, 20x1

Assets	Basis		FMV	
Cash	\$ 1,200		\$ 1,200	
Accounts receivable	0		10,000	
Bakery supplies	0		400	
Stock, ABC Corp.	500		2,000	
Equipment & vehicle	14,565		21,600	
Building	139,736		198,000	
Land	5,000		11,500	
Goodwill	4,167		45,000	
Total Assets	<u>\$165,168</u>	\$165,168	<u>\$289,700</u>	\$289,700
Liabilities				
Operating loan	\$ 0		\$ 0	
Mortgage	139,000		139,000	
Total liabilities	<u>\$139,000</u>	(139,000)	<u>\$139,000</u>	<u>(139,000)</u>
Net worth or capital account	26,168	\$ 26,168	150,700	\$150,700
Total liabilities and net worth	<u>\$165,168</u>		<u>\$289,700</u>	

Compute the inside and outside basis for both John and Lisa.

Situation 2, Table C
Year-end Capital Account Adjustments J & L Custom Cakes, LLC, 20x1

	John		Lisa	
	Tax Basis	Book or FMV	Tax Basis	Book or FMV
Beginning capital account	\$ 11,685	\$ 50,000	\$ 17,314	\$100,000
Capital contributions	0	0	0	0
Current year increase (decrease)	14,056	14,056	28,113	28,113
Capital withdrawals	(15,000)	(15,000)	(30,000)	(30,000)
Ending capital account	<u>\$ 10,741</u>	\$ 49,056	<u>\$ 15,427</u>	\$ 98,113

Situation 2, Table D
Basis Computation of Member's Interest for Year 20x1
J & L Custom Cakes, LLC December 31, 20x1, $\frac{1}{3}$ John – $\frac{2}{3}$ Lisa Ownership

	John	Lisa
Basis of member's interest at beginning of the year	\$ 61,685	\$117,314
Add:		
1. Cash contributed	\$ 0	\$ 0
2. Property contributed		
3. Increase in long-term notes and/or mortgage liabilities		
4. Increase in short-term notes		
5. Increase in accounts payable		
6. Salary and/or interest	33	67
7. Ordinary income	13,773	27,546
8. Capital gain	500	1,000
9. Non-taxable receipts		
10. Excess of depletion deduction over the basis of the depletable property		
11. Member's share of liability contributed by other members ¹		
Total	<u>\$ 14,306</u>	<u>\$ 28,613</u>
Subtract:		
12. Decrease in long-term notes and/or mortgage liabilities	\$ 3,667	\$ 7,333
13. Decrease in short-term and/or mortgage liabilities		
14. Decrease in accounts payable		
15. Non-deductible expense		
16. Draws ²	15,000	30,000
17. Other deductions ³	250	500
18. Liability assumed by other members contributed by this member		
Total	<u>\$ 18,917</u>	<u>\$ 37,833</u>
Basis of member's interest end of year prior to the taking of any ordinary and/or capital losses	\$ 57,074	\$108,094
Less share of LLC's debt	<u>(46,333)</u>	<u>(92,667)</u>
Capital account (line L, Schedule K-1)	\$10,741	\$ 15,427

¹ Liabilities that are carried to the partnership by any of the partners.

² Draw represents all items withdrawn from the partnership including salary and interest, ordinary income, cash, and property.

³ Reduction for IRC §179 deduction.

SITUATION 3. J & L CUSTOM CAKES, LLC WITH SPECIAL ALLOCATIONS ON CONTRIBUTED PROPERTY

J & L Custom Cakes, LLC has the same contributions on January 1, 20x1, but income and depreciation are allocated according to the contributing member.

Situation 3, Table A
Member Contributions
J & L Custom Cakes, LLC, January 1, 20x1

	John's Contributions				
	Basis	FMV	Built-in Gain/Loss	Book Depreciation	Tax Depreciation
Accounts receivable	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Bakery supplies	0	0	0	0	0
Stock	1,000	4,000	3,000	0	0
Mixer	1,286	1,300	14	108	367
Cash register	514	400	(114)	100	147
Display case	685	600	(85)	75	196
Building	0	0	0	0	0
Land	0	0	0	0	0
Goodwill	4,500	40,000	35,500	333	333
Total	\$ 7,985	\$ 46,300	\$ 38,315	\$ 616	\$ 1,043
	Lisa's Contributions				
	Basis	FMV	Built-in Gain/Loss	Book Depreciation	Tax Depreciation
Accounts receivable	\$ 0	\$ 15,000	\$ 15,000	\$ 0	\$ 0
Bakery supplies	0	600	600	0	0
Stock	0	0	0	0	0
Oven	1,714	1,500	(214)	54	245
Stove	612	600	(12)	21	88
Computer	1,275	1,000	(275)	333	480
Printer	480	500	20	167	192
Office furnishings	1,714	1,000	(714)	200	490
Delivery van	11,740	13,000	1,260	1,600	2,157
Kitchen equipment	0	2,000	2,000	200	0
Building	144,479	198,000	53,521	6,600	4,743
Land	5,000	11,500	6,500	0	0
Goodwill	0	5,000	5,000	2,667	0
Total	\$167,014	\$249,700	\$ 82,686	\$ 11,842	\$ 8,395

In order to determine the special depreciation allocations under IRC §704(c) use the following table.

Situation 3, Table B
Depreciation Allocation for Contributed Property
J & L Custom Cakes, LLC, December 31, 20x1

Depreciation Allocation for Property Contributed by John				
	Book Depreciation	Tax Depreciation	Allocation to Lisa	Remainder for John
Equipment (5 Yr)	\$ 0	\$ 0	\$ 0	\$ 0
Equipment (7 Yr) ¹	283	710	473	237
Buildings	0	0	0	0
Goodwill	333	333	222	111
Total John	<u>\$ 616</u>	<u>\$ 1,043</u>	<u>\$ 695</u>	<u>\$ 348</u>

Depreciation Allocation for Property Contributed by Lisa				
	Book Depreciation	Tax Depreciation	Allocation to John	Remainder for Lisa
Equipment (5 Yr) ¹	\$ 2,100	\$ 2,829	\$ 943	\$ 1,886
Equipment (7 Yr)	475	823	274	549
Buildings	6,600	4,743	2,200	2,543
Goodwill ¹	2,667	0	0	0
Total Lisa	<u>\$ 11,842</u>	<u>\$ 8,395</u>	<u>\$ 3,417</u>	<u>\$ 4,978</u>

¹ Because the book depreciation is less than the tax depreciation, depreciation is allocated according to the capital ratios.

\$5,000 of the sales were accounts receivable contributed by Lisa. Since they have zero basis, the entire \$5,000 is allocated to Lisa. The gain on the sale of the oven and stove, contributed by Lisa was \$107. The gain is allocated to her. The bakery supplies were used and not sold, so there is no income to allocate. One-half of the ABC Corporation stock was sold at a gain of \$1,500. Since the stock was contributed by John, the gain is allocated to him. The balance of the profit (\$45,650) for the year is split $\frac{1}{3} - \frac{2}{3}$ as is the interest income of \$100 and the §179 deduction of \$750.

SITUATION 4. SALE OF LLC ASSETS AND DISTRIBUTION OF CASH

After the end of the operating year, John and Lisa decided to dissolve their business by selling all assets and distributing the cash. Their balance sheet and FMV of assets at the time of sale were the same as the year-end balance sheet.

Calculate the gain on the asset sale.

Situation 4, Table A
Sale of LLC Assets Followed by Cash Distribution

Assets	Basis	FMV	Gain on Sale	
			Amount	Type
Cash	\$ 1,200	\$ 1,200	\$ 0	
Accounts receivable	0	10,000	10,000	OI
Bakery supplies	0	400	400	OI
Stock ABC Corp.	500	2,000	1,500	CG
Equipment & vehicle	14,565	21,600	7,035	DR
Building	139,736	198,000	58,264	CG
Land	5,000	11,500	6,500	CG
Goodwill	4,167	45,000	40,833	CG ¹
Total Assets	\$165,168	\$289,700	\$124,532	
Liabilities				
Operating loan	\$ 0	\$ 0	\$ 0	
Mortgage	139,000	139,000	0	
Total liabilities	\$139,000	\$139,000	\$ 0	
Net worth or capital account	<u>\$26,168</u>	<u>\$150,700</u>	<u>\$124,532</u>	
Total liabilities and net worth	\$165,168	\$289,700	\$124,532	

¹ A portion of the goodwill gain will qualify as \$1245 recapture.

OI=ordinary income; CG=capital gain; DR=depreciation recapture

Use the following table to determine the gain on the distribution of cash after the assets are sold and the mortgage is repaid.

Situation 4, Table B
Distribution of Cash in J & L Custom Cakes, LLC on Dissolution
Form 1065, Schedule M

	Beginning	+	Ordinary	+	=	Ending
	Capital		Income			Capital
LLC	\$26,168		\$ 17,435			\$150,700
Cash in LLC after sale			\$289,700			
Less payment of liabilities			(139,000)			
Cash available for distribution			\$150,700			
Ending capital account (basis)			(150,700)			
Gain on distribution of cash			\$ 0			

Calculate the entries which will appear on the LLCs Schedule M.

Situation 4, Table C
Schedule M Transactions for J & L Custom Cakes,
LLC Showing Final Sale and Distribution of Cash Only
Form 1065, Schedule M

	Beginning	+	Ordinary	+	Other	–	=	Remaining
	Capital		Income		Income			Basis
Johnn	\$ 10,741		\$ 5,812		\$ 35,699			\$ 2,019
Lisa	15,427		11,623		71,398			(2,019)
Total	\$ 26,168		\$ 17,435		\$ 107,097			\$ 0
	Gain or Loss							
Johnn must report a	loss	of	\$ 2,019	on his tax return.				
Lisa must report a	gain	of	\$ 2,019	on her tax return.				

SITUATION 5. PROPORTIONATE DISTRIBUTION OF ASSETS, FOLLOWED BY A SALE

After the end of the first operating year, John and Lisa decide to dissolve the LLC by distributing the assets and debts to each of the members on a pro rata basis, and then selling the assets. Calculate their respective shares of the FMV of each of the classes of assets.

Situation 5, Table A
Allocation of LLC FMV in J & L Custom Cakes, LLC
to John and Lisa on Dissolution, January 1, 20x2

Assets	LLCFMV	John's 1/3 Share FMV	Lisa's 2/3 Share FMV
Cash	\$ 1,200	\$ 400	\$ 800
Accounts receivable	10,000	3,333	6,667
Bakery supplies	400	133	267
Stock ABC Corp.	2,000	667	1,333
Equipment & vehicle	21,600	7,200	14,400
Building	198,000	66,000	132,000
Land	11,500	3,833	7,667
Goodwill	45,000	15,000	30,000
Total assets	\$289,700	\$ 96,566	\$193,134
Liabilities			
Operating loan	\$ 0	\$ 0	\$ 0
Mortgage	139,000	46,333	92,667
Total Liabilities	\$139,000	\$ 46,333	\$ 92,667
Net worth or capital account	150,700	50,233	100,467
Total liabilities and net worth	\$289,700	\$ 96,566	\$193,134

Next, allocate each member's basis between cash, unrealized receivables, and inventory.

Situation 5, Table B
Allocation of Basis in J & L Custom Cakes, LLC
on Dissolution

John's basis = capital account	\$ 10,741	+	Share of liabilities	\$ 46,333	=	\$ 57,074
Lisa's basis = capital account	15,427	+	Share of liabilities	92,667	=	108,094
LLC basis = capital account	\$ 26,168	+	Liabilities	\$139,000	=	\$165,168
	LLC Basis		John's Basis			Lisa's Basis
Total basis	\$165,168		\$ 57,074			\$108,094
Less cash	(1,200)		(400)			(800)
Balance	\$163,968		\$ 56,674			\$107,294
Unrealized receivables and substantially appreciated inventory						
	LLC Basis		John's Basis			Lisa's Basis
Accounts receivable	\$ 0		\$ 0			\$ 0
Bakery supplies	0		0			0
Depreciation recapture	0		0			0
Subtotal UR & SAI	\$ 0		\$ 0			\$ 0
Adjusted basis for allocation	\$163,968		\$ 56,674			\$107,294

Determine the basis for the other assets which are distributed to Lisa under procedures outlined in IRC §732(c).

Situation 5, Table C
Determining Basis for Lisa on Distribution of Other
Property from J & L Custom Cakes, LLC

	1	2	3	4	5	6	7
Assets	Share of LLC Basis	Share of FMV	Unrealized Depreciation	Share of Adjusted Basis	Percentage of Basis	Reduction	Substitute Basis
Stock ABC Corp.	\$ 334	\$ 1,334	\$ 0	\$ 334	0.33%	\$ 7	\$ 327
Equipment & vehicle	9,710	14,400	0	0	0.00%	0	9,710
Building	93,158	132,000	0	93,158	93.53%	1,890	91,268
Land	3,334	7,666	0	3,334	3.35%	68	3,266
Goodwill	2,778	30,000	0	2,778	2.79%	56	2,722
Total assets	\$109,314	\$185,400	\$ 0	\$99,604	100.00%	\$ 2,021	\$107,293

Lisa's remaining outside basis for allocation is \$107,294, which is less than her share of the LLC's inside basis of \$109,314. Therefore, she reduces the basis of assets received by \$2,020, as none of the assets have an FMV less than the LLC basis. The decrease is allocated in the same percentage as the share of the basis of each asset is allocated on the LLC books.

An exception applies to assets that require depreciation recapture. The unrealized depreciation is \$0 if the FMV is greater than the share of LLC basis.

Determine the basis of the other assets which are distributed to John under procedures outlined in IRC §732(c).

Situation 5, Table D
Determining Basis for John on Distribution of Other
Property from J & L Custom Cakes, LLC

Assets	1	2	3	4 Percent Unrealized Appreciation	5	6 Substitute Basis
	Share of LLC Basis	Share of FMV	Unrealized Appreciation		Allocation	
Stock ABC Corp.	\$ 167	\$ 667	\$ 500	1.40%	\$ 28	\$ 195
Equipment & vehicle	4,855	7,200	0	0.00%	0	4,855
Building	46,579	66,000	19,421	54.40%	1,098	47,677
Land	1,667	3,833	2,166	6.07%	122	1,789
Goodwill	1,389	15,000	13,611	38.13%	769	2,158
Total assets	\$ 54,657	\$ 92,700	\$ 35,698	100.00%	\$ 2,017	\$ 56,674

Determine the sales results for John and Lisa in the tables below.

John's remaining outside basis for allocation is \$56,674, which is greater than her \$54,657 share of the LLC basis. He is first allocated his share of the LLC inside basis. Next, he is allocated the additional \$2,017 (\$56,674 – \$54,657) which is prorated by the percentage of unrealized appreciation.

No unrealized appreciation is allocated to depreciation recapture items.

Situation 5, Table E
Determining Gain for John on Sale of his
1/3 Share of LLC Assets after a Prorated Distribution

Assets	Adjusted Basis	FMV	John's Gain	Type
Cash	\$ 400	\$ 400	\$ 0	
Accounts receivable	0	3,333	3,333	OI
Bakery supplies	0	133	133	OI
Stock ABC Corp.	195	667	472	CG
Equipment & vehicle	4,855	7,200	2,345	DR
Building	47,677	66,000	18,323	CG
Land	1,789	3,833	2,044	CG
Goodwill	2,158	15,000	12,842	CG
Total assets	\$ 57,074	\$ 96,566	\$ 39,492	

OI=ordinary income; CG=capital gain; DR=depreciation recapture

Situation 5, Table F
Determining Gain for Lisa on Sale of her
 $\frac{2}{3}$ Share of LLC Assets after a Prorated Distribution

Assets	Adjusted Basis	FMV	Lisa's Gain	Type
Cash	\$ 800	\$ 800	\$ 0	
Accounts receivable	0	6,667	6,667	OI
Bakery supplies	0	267	267	OI
Stock ABC Corp.	327	1,333	1,006	CG
Equipment & vehicle	9,710	14,400	4,690	DR
Building	91,268	132,000	40,732	CG
Land	3,266	7,667	4,401	CG
Goodwill	2,722	30,000	27,278	CG
Total assets	\$108,093	\$193,134	\$85,041	

OI=ordinary income; CG=capital gain; DR=depreciation recapture

Use the following table to compare the results from Situation 4 to Situation 5.

Situation 5, Table G
Comparison of Sales of Assets within the
LLC (Situation 4) and Distribution of Assets
with Sale Outside the LLC (Situation 5)

	Situation 4 Sale by the LLC	Situation 5 Sale by the Individuals
John		
IRC §1231 gain	\$ 35,699	\$ 33,681
Depreciation recapture	2,345	2,345
Ordinary income	3,467	3,466
Capital gain on distribution	(2,019)	0
Net gain ^a	\$ 39,492	\$ 39,492
Lisa		
IRC §1231 gain	\$ 71,398	\$ 73,417
Depreciation recapture	4,690	4,690
Ordinary income	6,934	6,934
Capital gain on distribution	2,018	0
Net gain ^a	\$ 85,040	\$ 85,041

^a Difference between net gain in Situation 4 and 5 is due to rounding.

SITUATION 6. PROPORTIONATE DISTRIBUTION OF ASSETS, EACH MEMBER TAKING SPECIFIC ASSETS

John and Lisa decide to dissolve their LLC as in Situation 5. When assets and liabilities are distributed, each member takes specific assets. John wants the equipment and Lisa wants the delivery van, land, building and inventory. To prevent the deemed sale of §751 property between the members and the LLC, they carefully allocate the §751 property so John receives $\frac{1}{3}$ of the property and Lisa receives $\frac{2}{3}$. They accomplish this by each first selecting the assets with potential depreciation recapture associated with them and then dividing the accounts receivable in such a way that John receives his share and Lisa her share. Because there is not enough asset value to allow Lisa to receive all of the land and building, they decide to give John an undivided 15% interest and Lisa an undivided 85% interest. The cash is divided $\frac{1}{3} - \frac{2}{3}$ and the goodwill is split in an amount to make each member receive enough FMV to balance to her respective share of FMV as determined in Table A.

If they take assets they contributed, the pre-contribution gain from depreciation recapture does not have to be allocated according to their capital share.¹ However, post-contribution depreciation must be allocated.

If they decide to accept specific liabilities in other than a $\frac{1}{3} - \frac{2}{3}$ ratio, then adjustments to their basis for the acceptance of each member's share of LLC liabilities and individual assumption of specific liabilities are made prior to Step 1 in Table C.

Use Table A to indicate the IRC §751 assets and non-IRC §751 assets.

Situation 6, Table A
Allocation of LLC FMV Between
Capital Assets and §751 Property

Assets	LLCFMV	IRC §751 Asset	Capital or Other than IRC §751 Asset
Cash	\$ 1,200	\$ 0	\$ 1,200
Accounts receivable	10,000	10,000	0
Bakery supplies	400	400	0
Stock ABC Corp.	2,000	0	2,000
Equipment & vehicle	21,600	7,035	14,565
Building	198,000	0	198,000
Land	11,500	0	11,500
Goodwill	45,000	0	45,000
Total assets	\$289,700	\$ 17,435	\$272,265
John's $\frac{1}{3}$ share	\$ 96,567	\$ 5,812	\$ 90,755
Lisa's $\frac{2}{3}$ share	\$193,133	11,623	\$181,510

¹ IRC §704(c)

Use Table B to allocate the assets between John and Lisa.

Situation 6, Table B
Allocation of LLC FMV in J & L Custom Cakes, LLC to
John and Lisa in a Proportionate Specific Allocation

Assets	LLC FMV	John		Lisa	
		FMV	\$751 Property	FMV	\$751 Property
Cash	\$ 1,200	\$ 400	\$ 0	\$ 800	\$ 0
Accounts receivable	10,000	2,194	2,194	7,806	7,806
Bakery supplies	400	0	0	400	400
Stock ABC Corp.	2,000	2,000	0	0	0
Equipment & vehicle	21,600	8,600	3,618	13,000	3,417
Building	198,000	39,600	0	158,400	0
Land	11,500	1,725	0	9,775	0
Goodwill	45,000	42,048	0	2,952	0
Total assets	\$289,700	\$96,567	\$ 5,812	\$193,133	\$11,623

Using Table C, determine the remaining basis of the assets after allocations for cash, unrealized receivables, and inventory.

Allocate the basis to the remaining assets of each member by using Tables D & E.

Situation 6, Table C
Allocation of Basis and FMV in J & L Custom Cakes,
LLC to John and Lisa on Dissolution, January 1, 20x2

John's basis = capital account	\$ 10,741	+	Share of liabilities	\$ 46,333	=	\$ 57,074
Lisa's basis = capital account	15,427	+	Share of liabilities	92,667	=	108,093
LLC Basis = capital account	\$ 26,168	+	Liabilities	\$139,000	=	\$165,168

	LLC Basis	John		Lisa	
		FMV	Basis	FMV	Basis
Step 1. Total basis	\$165,168	\$96,567	\$57,074	\$193,133	\$108,093
Less cash	(1,200)	(400)	(400)	(800)	(800)
Balance	\$163,968	\$96,167	\$56,674	\$192,333	\$107,293
Step 2. Unrealized receivables and substantially appreciated inventory.					
Accounts receivable	\$ 0	\$ 2,194	\$ 0	\$ 7,806	\$ 0
Bakery supplies	0	0	0	400	0
Depreciation recapture	0	3,618	0	3,417	0
Subtotal	\$ 0	\$ 5,812	\$ 0	\$11,623	\$ 0
Remaining FMV & basis for allocation	\$163,968	\$90,355	\$56,674	\$180,710	\$107,293

Situation 6, Table D
Allocation of Basis and FMV of Other Property in J & L
Accounting, LLC to Lisa on Dissolution

	1	2	3	4	5	6	7
Assets	Share of LLC Basis	Share of FMV	Unrealized Depreciation	Share Adjusted Basis	Percent Adjusted Basis	Reduction	Substitute Basis
Vehicle	\$ 9,583	\$ 13,000	\$ 0	\$ 9,583	7.63%	\$ (1,400)	\$ 8,183
Building	111,789	158,400	0	111,789	88.97%	(16,328)	95,461
Land	4,000	9,775	0	4,000	3.18%	(584)	3,416
Goodwill	273	2,952	0	273	0.22%	(40)	233
Total	\$125,645	\$184,127	\$ 0	\$125,645	100.00%	\$ (18,351)	\$107,293

Situation 6, Table E
Allocation of Basis and FMV of Other Property in C & J
Accounting, LLC to John on Dissolution

	1	2	3	4	5	6
Assets	Share of LLC Basis	Share of FMV	Unrealized Appreciation	Percent Unrealized Appreciation	Allocation	Substitute Basis
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500	2.88%	\$ 528	\$ 1,028
Equipment	4,982	8,600	0	0.00%	0	4,982
Building	27,947	39,600	11,653	22.40%	4,111	32,058
Land	1,000	1,725	725	1.39%	255	1,255
Goodwill	3,894	42,048	38,154	73.33%	13,457	17,351
Total	\$ 38,323	\$ 93,973	\$ 52,032	100.00%	\$ 18,351	\$ 56,674

No allocation is made to the equipment as the FMV is greater than its basis.

SITUATION 7. SALE OF A PARTIAL OR TOTAL INTEREST — LLC NOT TERMINATED

On January 1, 20x2, Lisa decides to sell half of her $\frac{2}{3}$ interest in J & L Custom Cakes, LLC to Gabe. This forms a new equal $\frac{1}{3}$ LLC of John, Lisa and Gabe. Since only $\frac{1}{3}$ of the member interest is being sold, the LLC does not terminate.

Use Table A to allocate the bases of the LLC assets between John and Lisa.

Situation 7, Table A
Allocation of Basis in J & L Custom Cakes, LLC to Lisa on January 1, 20x2
(See Situation 5 for details of this transaction)

John's basis = capital account	\$ 10,741	+	Share of liabilities	\$ 46,333	=	\$ 57,074
Lisa's basis = capital account	15,427	+	Share of liabilities	92,667	=	108,093
LLC basis = capital account	<u>\$ 26,168</u>	+	Liabilities	<u>\$139,000</u>	=	<u>\$165,168</u>

	LLC Basis	John's Basis	Lisa's Basis
Total basis	\$165,168	\$ 57,074	\$108,093
Less cash	(1,200)	(400)	(800)
Balance	\$163,968	\$ 56,674	\$107,293

Unrealized receivables and substantially appreciated inventory

	LLC Basis	John's Basis	Lisa's Basis
Accounts receivable	\$ 0	\$ 0	\$ 0
Bakery supplies	0	0	0
Depreciation recapture	0	0	0
Subtotal UR & SAI	\$ 0	\$ 0	\$ 0
Adjusted basis for allocation	\$163,968	\$ 56,674	\$107,293
Stock ABC Corp.	\$ 500	\$ 195	\$ 327
Equipment & vehicle	14,565	4,855	9,710
Building	139,736	47,677	91,268
Land	5,000	1,789	3,266
Goodwill	<u>4,167</u>	<u>2,158</u>	<u>2,722</u>
Total	\$163,968	\$ 56,674	\$107,293

Use Table B to show the sale of $\frac{1}{2}$ of Lisa's share to Gabe.

Situation 7, Table B
Sale of Lisa's $\frac{1}{2}$ Interest in J & L Custom Cakes, LLC to Gabe

Assets	Lisa's $\frac{2}{3}$ Share		Sale of $\frac{1}{2}$ of Lisa's Share to Gabe		Gain to Lisa	
	Adjusted Basis	FMV	Adjusted Basis	FMV		
Cash	\$ 800	\$ 800	\$ 400	\$ 400	\$ 0	
Accounts receivable	0	6,667	0	3,334	3,334	OI
Bakery supplies	0	267	0	134	134	OI
Stock ABC Corp.	327	1,333	164	667	503	CG
Equipment & vehicle	9,710	14,400	4,855	7,200	2,345	DR
Building	91,268	132,000	45,634	66,000	20,366	CG
Land	3,266	7,667	1,633	3,834	2,201	CG
Goodwill	<u>2,722</u>	30,000	<u>1,361</u>	15,000	<u>13,639</u>	CG
Total assets	\$108,093	\$193,134	\$ 54,047	\$ 96,567	\$ 42,520	
Liabilities and capital						
Liabilities	\$ 92,667	\$ 92,667	\$ 46,333	\$ 46,333		
Capital	<u>15,427</u>	100,467	<u>7,714</u>	50,234		
Total	\$108,093	\$193,134	\$ 54,047	\$ 96,567		

OI=ordinary income; CG=capital gain; DR=depreciation recapture

Calculate Lisa's gain by using Table C.

Situation 7, Table C
**Sale of Lisa's $\frac{1}{2}$ Interest in J
& L Custom Cakes, LLC to Gabe**
Calculation of Profit and Allocation of Gain

Cash or notes received by Lisa	\$ 50,234
Liabilities assumed by Gabe ($\frac{1}{3}$ of \$139,000)	46,333
Amount realized	<u>\$ 96,567</u>
Lisa's basis in the $\frac{1}{2}$ interest	(54,047)
Lisa's total gain	\$ 42,520
Lisa's ordinary income and depreciation recapture (Table C) Part II, Form 4797	<u>(5,813)</u>
Lisa's capital gain (Table C) Part II Schedule D	<u>\$ 36,707</u>

Allocate the basis of the LLC property under IRC §743(b) for Gabe using Tables D & E.

Situation 7, Table D
Allocation of Basis of LLC Property under IRC §743(b) for Gabe

	Partnership Assets		
	Adjusted Basis	FMV	Difference
IRC §§1221 and 1231 property			
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500
Equipment	14,565	21,600	7,035
Buildings	139,736	198,000	58,264
Land	5,000	11,500	6,500
Goodwill	<u>4,167</u>	<u>45,000</u>	<u>40,833</u>
Total	\$163,968	\$278,100	\$114,132
Other property			
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable	0	10,000	10,000
Bakery supplies	<u>0</u>	<u>400</u>	<u>400</u>
Total	\$ 1,200	\$11,600	\$10,400
Total assets	\$165,168	\$289,700	\$124,532

Situation 7, Table E
Calculation of Special Allocation for Gabe after Purchase of LLC Interest

Cash paid	\$ 50,234
Liabilities assumed	<u>46,333</u>
Gabe's outside basis	\$ 96,567
Gabe's inside basis = 1/3 of LLC adjusted basis	<u>(55,056)</u>
Amount of adjustment	\$ 41,511

	Difference between FMV and LLC Basis	Percent		Member Adjustment	Amount of Adjustment
Step 1					
A) Capital assets	\$114,132	91.65%	×	\$ 41,511	\$ 38,044
B) Other property	<u>10,400</u>	<u>8.35%</u>	×	41,511	<u>3,467</u>
Total adjustment	\$124,532	100.00%			41,511
Step 2					
A) IRC §§1221 and 1231 property					
Stock ABC Corp.	\$ 1,500	1.31%	×	\$ 38,044	\$ 500
Equipment & vehicle	7,035	6.16%	×	38,044	2,345
Building	58,264	51.05%	×	38,044	19,421
Land	6,500	5.70%	×	38,044	2,167
Goodwill	<u>40,833</u>	<u>35.78%</u>	×	38,044	<u>13,611</u>
Total adjustment	\$114,132	100.00%			\$38,044
B) Other Property					
Accounts receivable	\$ 10,000	96.15%	×	\$ 3,467	\$ 3,333
Bakery supplies	<u>400</u>	<u>3.85%</u>	×	3,467	<u>133</u>
Total	\$ 10,400	100.00%			\$ 3,467
Total					\$41,511

SITUATION 8. SALE OF A TOTAL LLC INTEREST WITH LLC TERMINATED

On January 1, 20x2, Lisa decides to sell her total interest in the J & L Custom Cakes, LLC to John and Gabe, who become equal members. As in **Situation 7**, the first step is to allocate the basis of the selling member's LLC interest to the LLC assets (**Table 8A**) to determine the classification of Lisa's gain.

Use Table A to determine Lisa's bases in the assets of the LLC.

Situation 8, Table A
Allocation of Basis in J & L Custom Cakes, LLC to Lisa on January 1, 20x2
(See Situation 5 for details of this transaction)

John's basis = capital account	\$ 10,741	+	Share of liabilities	\$ 46,333	=	\$ 57,074
Lisa's basis = capital account	15,427	+	Share of liabilities	92,667	=	108,093
LLC basis = capital account	\$ 26,168	+	Liabilities	\$139,000	=	\$165,168
	LLC Basis		John's Basis			Lisa's Basis
Total basis	\$165,168		\$ 57,074			\$108,093
Less cash	(1,200)		(400)			(800)
Balance	\$163,968		\$ 56,674			\$107,293
Unrealized receivables and substantially appreciated inventory						
	LLC Basis		John's Basis			Lisa's Basis
Accounts receivable	\$ 0		\$ 0			\$ 0
Bakery supplies	0		0			0
Depreciation recapture	0		0			0
Subtotal UR & SAI	\$ 0		\$ 0			\$ 0
Adjusted basis for allocation	\$163,968		\$ 56,674			\$107,293
Stock ABC Corp.	\$ 500		\$ 195			\$ 327
Equipment & vehicles	14,565		4,855			9,710
Building	139,736		47,677			91,268
Land	5,000		1,789			3,266
Goodwill	4,167		2,158			2,722
	\$163,968		\$ 56,674			\$107,293

Since Lisa has a greater than 50% interest in the John & Lisa Accounting LLC, the sale of her interest terminates the LLC. The sale requires allocation of Lisa's basis of her share of the assets as in **Situation 5, Table B**. Lisa sells $\frac{1}{4}$ of her interest to John. Use Table B to determine Lisa's gain on the $\frac{1}{4}$ interest.

Situation 8, Table B
Sale of $\frac{2}{3}$ Interest of Lisa in
J & L Custom Cakes, LLC — Sale of 25% of Lisa's Interest to John

Assets	Lisa's $\frac{2}{3}$ Share		Sale of 25% of Lisa's Share to John		Gain to Lisa	
	Adjusted Basis	FMV	Adjusted Basis	FMV		
Cash	\$ 800	\$ 800	\$ 200	\$ 200	\$ 0	
Accounts receivable	0	6,667	0	1,667	1,667	OI
Bakery supplies	0	267	0	67	67	OI
Stock ABC Corp.	327	1,333	82	333	251	CG
Equipment & vehicle	9,710	14,400	2,428	3,600	1,172	DR
Building	91,268	132,000	22,817	33,000	10,183	CG
Land	3,266	7,667	817	1,917	1,100	CG
Goodwill	<u>2,722</u>	<u>30,000</u>	<u>680</u>	<u>7,500</u>	<u>6,820</u>	CG
Total assets	\$108,093	\$193,134	\$ 27,024	\$ 48,284	\$ 21,260	
Liabilities and capital						
Liabilities	\$ 92,667	\$ 92,667	\$ 23,167	\$ 23,167		
Capital	<u>15,427</u>	<u>100,467</u>	<u>3,857</u>	<u>25,117</u>		
Total	\$108,093	\$193,134	\$ 27,024	\$ 48,284		

OI=ordinary income; CG=capital gain; DR=depreciation recapture

Use Table C below to determine the gain on the $\frac{3}{4}$ interest sold to Gabe.

Situation 8, Table C
Sale of $\frac{2}{3}$ Interest of Lisa in J & L Custom Cakes, LLC
— Sale of 75% of Lisa's Interest to Gabe

Assets	Lisa's $\frac{2}{3}$ Share		Sale of 75% of Lisa's Share to Gabe		Gain to Lisa	
	Adjusted Basis	FMV	Adjusted Basis	FMV		
Cash	\$ 800	\$ 800	\$ 600	\$ 600	\$ 0	
Accounts receivable	0	6,667	0	5,000	5,000	OI
Bakery supplies	0	267	0	200	200	OI
Shares ABC Corp.	327	1,333	245	1,000	755	CG
Equipment & vehicle	9,710	14,400	7,283	10,800	3,517	DR
Building	91,268	132,000	68,451	99,000	30,549	CG
Land	3,266	7,667	2,450	5,750	3,300	CG
Goodwill	<u>2,722</u>	<u>30,000</u>	<u>2,041</u>	<u>22,500</u>	<u>20,459</u>	CG
Total assets	\$108,093	\$193,134	\$81,070	\$144,850	\$ 63,780	
Liabilities and capital						
Liabilities	\$ 92,667	\$ 92,667	\$ 69,500	\$ 69,500		
Capital	<u>15,427</u>	<u>100,467</u>	<u>11,570</u>	<u>75,351</u>		
Total	\$108,094	\$193,134	\$81,070	\$144,851		

OI=ordinary income; CG=capital gain; DR=depreciation recapture

Table D is used to show Lisa's total gain from the sale.

Situation 8, Table D
Taxable Gain from Sale of Lisa's Former LLC
Interest - 25% to John and 75% to Gabe

Assets	Gain to Lisa Sale to John	Gain to Lisa Sale to Gabe	Total Gain	
Cash	\$ 0	\$ 0	\$ 0	
Accounts receivable	1,667	5,000	6,667	OI
Bakery supplies	67	200	267	OI
Stock ABC Corp.	251	755	1,006	CG
Equipment & vehicle	1,172	3,517	4,689	DR
Building	10,183	30,549	40,732	CG
Land	1,100	3,300	4,400	CG
Goodwill	<u>6,820</u>	<u>20,459</u>	<u>27,279</u>	CG
Total	\$ 21,260	\$ 63,780	\$ 85,040	

Assume John and Gabe want to make an IRC §743(b) election. Use Tables E to begin the process.

Situation 8, Table E
Allocation of Basis of LLC Property
under IRC §743(b) for John and Gabe

	Adjusted Basis	FMV	Difference
IRC §§1221 and 1231 property			
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500
Equipment & vehicle	14,565	21,600	7,035
Building	139,736	198,000	58,264
Land	5,000	11,500	6,500
Goodwill	<u>4,167</u>	<u>45,000</u>	<u>40,833</u>
Total	\$163,968	\$278,100	\$114,132
Other property			
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable	0	10,000	10,000
Bakery supplies	<u>0</u>	<u>400</u>	<u>400</u>
Total	\$ 1,200	\$11,600	\$ 10,400
Total assets	\$165,168	\$289,700	\$124,532

Use Table F to determine the amount of Gabe's adjustment.

Situation 8, Table F
Calculation of Special Allocation for Gabe
after Purchase of a 50% LLC Interest from Lisa

50% of J & L Custom Cakes, LLC				
	Gabe's Outside Basis	Gabe's Share of Inside Basis		Difference
IRC §§1221 and 1231 property				
Stock ABC Corp.	\$ 1,000	\$ 250		\$ 750
Equipment & vehicle	10,800	7,283		3,517
Building	99,000	69,868		29,132
Land	5,750	2,500		3,250
Goodwill	<u>22,500</u>	<u>2,084</u>		<u>20,416</u>
Total	\$139,050	\$81,985		\$57,065
Cash	\$ 600	\$ 600		\$ 0
Accounts receivable	5,000	0		5,000
Bakery supplies	<u>200</u>	<u>0</u>		<u>200</u>
Total	\$ 5,800	\$ 600		\$ 5,200
Total assets	\$144,850	\$82,585		\$62,265
	Difference between FMV and LLC Basis	Percent	Member Adjustment	Amount of Adjustment
Step 1				
A) Capital assets	\$114,132	91.65% ×	\$ 62,265	\$57,065
B) Other property	<u>10,400</u>	<u>8.35%</u> ×	<u>62,265</u>	<u>5,200</u>
Total adjustment	\$124,532	100.00%	\$124,530	\$62,265
Step 2				
A) IRC §§1221 and 1231 property				
Stock ABC Corp.	\$ 1,500	1.31% ×	\$ 57,065	\$ 750
Equipment & vehicle	7,035	6.16% ×	57,065	3,517
Building	58,264	51.05% ×	57,065	29,132
Land	6,500	5.70% ×	57,065	3,250
Goodwill	<u>40,833</u>	<u>35.78%</u> ×	57,065	<u>20,416</u>
Total adjustment	\$114,132	100.00%		\$57,065
B) Other Property				
Cash	\$ 0	0.00% ×	\$ 5,200	\$ 0
Accounts receivable	10,000	96.15% ×	5,200	5,000
Bakery supplies	<u>400</u>	<u>3.85%</u> ×	5,200	<u>200</u>
Total	\$10,400	100.00%		\$ 5,200
Total	\$124,532			\$62,265

Next, use Table G to recombine Gabe's $\frac{1}{2}$ of his LLC basis with his special basis allocation.

Situation 8, Table G
Recombination of Gabe's $\frac{1}{2}$ of the LLC Basis from J
& L Custom Cakes, LLC and His Special Allocation

Asset	LLC Basis	50% of Basis	Special Allocation	New Basis Allocation
Cash	\$ 1,200	\$ 600	\$ 0	\$ 600
Accounts receivable	0	0	5,000	5,000
Bakery supplies	0	0	200	200
Stock ABC Corp.	500	250	750	1,000
Equipment & vehicle	14,565	7,283	3,517	10,800
Building	139,736	69,868	29,132	99,000
Land	5,000	2,500	3,250	5,750
Goodwill	<u>4,167</u>	<u>2,084</u>	<u>20,416</u>	<u>22,500</u>
Total assets	\$165,168	\$82,585	\$62,265	\$144,850

Table H can be used to determine the amount of John's adjustment.

Situation 8, Table H
Calculation of Special Allocation for John after Purchase of a 1/6 LLC Interest from Lisa

50% of J & L Custom Cakes, LLC					
	John's Outside Basis	John's Share of Inside Basis		Difference	
IRC §§1221 and 1231 property					
Stock ABC Corp.	\$ 333	\$ 83		\$ 250	
Equipment & vehicle	3,600	2,428		1,172	
Building	33,000	23,289		9,711	
Land	1,917	833		1,084	
Goodwill	<u>7,500</u>	<u>695</u>		<u>6,805</u>	
Total	\$ 46,350	\$ 27,328		\$ 19,022	
Cash	\$ 200	\$ 200		\$ 0	
Accounts receivable	1,667	0		1,667	
Bakery supplies	<u>67</u>	<u>0</u>		<u>67</u>	
Total	\$ 1,933	\$ 200		\$ 1,733	
Total assets	\$ 48,283	\$ 27,528		\$ 20,755	
	Difference between FMV and LLC Basis	Percent		Member Adjustment	Amount of Adjustment
Step 1					
A) Capital assets	\$114,132	91.65%	×	\$ 20,755	\$ 19,022
B) Other property	<u>10,400</u>	<u>8.35%</u>	×	20,755	<u>1,733</u>
Total adjustment	124,532	100.00%			\$ 20,755
Step 2					
A) IRC §§1221 and 1231 property					
Stock ABC Corp.	\$ 1,500	1.31%	×	\$ 19,022	\$ 250
Equipment & vehicle	7,035	6.16%	×	19,022	1,173
Building	58,264	51.05%	×	19,022	9,711
Land	6,500	5.70%	×	19,022	1,083
Goodwill	<u>40,833</u>	<u>35.78%</u>	×	19,022	<u>6,806</u>
Total adjustment	\$114,132	100.00%			\$ 19,022
B) Other Property					
Accounts receivable	\$ 10,000	96.15%	×	\$ 1,733	\$ 1,667
Bakery supplies	<u>400</u>	<u>3.85%</u>	×	1,733	<u>67</u>
Total	\$ 10,400	100.00%			\$ 1,733
Total	\$124,532				\$ 20,755

John's new basis allocation can be determined using Table I.

Situation 8, Table I
Recombination of John's $\frac{1}{3}$ Interest in J & L
Custom Cakes, LLC with the Purchase From Lisa

Assets	LLC Basis	Purchased 16.7% Basis	+ Special Allocation	+ John's $\frac{1}{3}$ Interest	= New Basis Allocation
Cash	\$ 1,200	\$ 200	\$ 0	\$ 400	\$ 600
Accounts receivable	0	0	1,667	0	1,667
Bakery supplies	0	0	67	0	67
Stock ABC Corp.	500	83	250	167	500
Equipment & vehicle	14,565	2,428	1,173	4,855	8,456
Building	139,736	23,289	9,711	46,579	79,579
Land	5,000	833	1,083	1,667	3,583
Goodwill	4,167	695	6,806	1,389	8,890
Total assets	<u>\$165,168</u>	<u>\$27,528</u>	<u>\$20,755</u>	<u>\$55,057</u>	<u>\$103,340</u>

Finally, John and Gabe's basis can be recombined.

Situation 8, Table J
Recombination of John's and Gabe's Basis in
Assets Distributed from J & L Custom Cakes, LLC

Asset	John's Basis	Gabe's Basis	J & L Custom Cakes, LLC
Cash	\$ 600	\$ 600	\$ 1,200
Accounts receivable	1,667	5,000	6,667
Bakery supplies	67	200	267
Stock ABC Corp.	500	1,000	1,500
Equipment & vehicle	8,456	10,800	19,256
Building	79,579	99,000	178,579
Land	3,583	5,750	9,333
Goodwill	<u>8,890</u>	<u>22,500</u>	<u>31,390</u>
Total assets	<u>\$103,342</u>	<u>\$144,850</u>	<u>\$248,192</u>

**SITUATION 9. SALE OF AN LLC INTEREST WITH
THE §754 ELECTION NOT MADE FOR THE NEW MEMBER INTERESTS**

Use the same scenario as **Situation 8**, except no §754 election is in effect. Therefore, the outside basis for the $\frac{1}{6}$ share purchased by John is not recognized by a special allocation of the difference between John's additional share of the inside basis and his outside basis. If the §754 election was made, he could receive an additional \$20,755 of basis applied to the share of the assets purchased as in **Situation 8, Table H**. For Gabe, the difference is \$62,265. (**Situation 8, Table F**).

Situation 9, Table A
**Difference in Assets' Basis Between Making and Not Making the
§754 Election for J & L Custom Cakes, LLC Members**

Assets	754 Election Made	754 Election Not Made	Difference in Basis
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable	6,667	0	6,667
Bakery supplies	267	0	267
Stock ABC Corp.	1,500	500	1,000
Equipment & vehicle	19,256	14,565	4,691
Building	178,578	139,736	38,842
Land	9,333	5,000	4,333
Goodwill	31,390	4,167	27,223
Total basis	\$248,190	\$165,168	\$ 83,022

**SITUATION 10. COMPLETE WITHDRAWAL (LIQUIDATION)
OF A MEMBER WITH A SINGLE PAYMENT**

On January 1, Lisa decides to withdraw from J & L Custom Cakes, LLC, LLC. Use the same balance sheet as January 1, 20x2 from **Situation 7, Table A**, which shows the outcome after Lisa sold 1/2 of her LLC interest to Gabe.

The decision is made to liquidate Lisa's remaining interest rather than John and Gabe purchasing Lisa's interest as in **Situation 8**.

Use Table A to calculate Lisa's and John's bases.

Situation 10, Table A
Allocation of Basis in J & L Custom Cakes, LLC to Lisa on January 1, 20x2

John's basis = capital account	\$ 10,741	+	Share of liabilities	46,333	=	\$ 57,074
Lisa's Basis = capital account	15,427	+	Share of liabilities	92,667	=	108,093
LLC Basis = capital account	\$ 26,168	+	Liabilities	\$139,000	=	\$165,168

	LLC Basis	John's Basis	Lisa's Basis
Total basis	\$165,168	\$ 57,074	\$108,093
less cash	(1,200)	(400)	(800)
Balance	\$163,968	\$ 56,674	\$107,293

Unrealized receivables and substantially appreciated inventory

	LLC Basis	John's Basis	Lisa's Basis
Accounts receivable	\$ 0	\$ 0	\$ 0
Bakery supplies	0	0	0
Depreciation recapture	0	0	0
Subtotal UR & SAI	\$ 0	\$ 0	\$ 0
Adj. basis for allocation	\$163,968	\$ 56,674	\$107,293
Stock ABC Corp.	\$ 500	\$ 195	\$ 327
Equipment & vehicle	14,565	4,855	9,710
Building	139,736	47,677	91,268
Land	5,000	1,789	3,266
Goodwill	4,167	2,158	2,722
Total	\$163,968	\$ 56,674	\$107,293

For liquidations after August 5, 1997, all LLC liquidations require an allocation of ordinary income property for the liquidated member since there is no longer a test for appreciated inventory. Therefore, Lisa's LLC interest must be allocated to her share. Use Table B for this calculation.

Use Table B to show the gain on the respective classes of property.

Situation 10, Table B
Liquidation of Remaining Lisa's $\frac{1}{3}$ Interest in J & L Custom Cakes, LLC

Assets	Lisa's $\frac{2}{3}$ Share		Liquidation of Lisa's $\frac{1}{3}$ Share		Gain to Lisa	
	Adjusted Basis	FMV	Adjusted Basis	FMV		
Cash	\$ 800	\$ 800	\$ 400	\$ 400	\$ 0	
Accounts receivable	0	6,667	0	3,334	3,334	
Bakery supplies	0	267	0	134	134	OI
Stock ABC Corp.	327	1,333	164	667	503	CG
Equipment & vehicle	9,710	14,400	4,855	7,200	2,345	DR
Building	91,268	132,000	45,634	66,000	20,366	CG
Land	3,266	7,667	1,633	3,834	2,201	CG
Goodwill	<u>2,722</u>	<u>30,000</u>	<u>1,361</u>	<u>15,000</u>	<u>13,639</u>	CG
Total assets	\$108,093	\$193,134	\$54,047	\$96,569	\$42,522	
Liabilities and capital						
Liabilities	\$ 92,667	\$ 92,667	\$ 46,333	\$ 46,333		
Capital	<u>15,427</u>	<u>100,467</u>	<u>7,713</u>	<u>50,236</u>		
Total	\$108,093	\$193,134	\$54,046	\$96,569		

OI = ordinary income; CG = capital gain; DR = depreciation recapture

Liquidation differs from a sale. Complete **Table C** to show a classification of the liquidation payments into the following three categories:

1. §736(b) payments for capital gain property,
2. §736(b) payments for ordinary income property, and
3. §736(a) payments for other.

Situation 10, Table C
Classification of Liquidation Payments for Lisa on
Liquidation of her LLC Interest with a Single Cash Payment

Type of Property	Adjusted Basis of Interest	FMV of Lisa's Interest ¹	Gain
IRC §736(b) payments for capital gain property			
Cash	\$ 400	\$ 400	\$ 0
Stock ABC Corp.	164	667	503
Equipment & vehicle	4,855	4,855	0
Building	45,634	66,000	20,366
Land	1,633	3,834	2,201
Goodwill	1,361	15,000	13,639
Total	<u>\$ 54,047</u>	<u>\$ 90,756</u>	<u>\$ 36,709</u>
IRC §736(b) payments for substantially appreciated inventory			
Accounts receivable	\$ 0	\$ 3,334	\$ 3,334
Bakery supplies	0	134	134
Depreciation recapture	0	2,345	2,345
Total	<u>\$ 0</u>	<u>\$ 5,813</u>	<u>\$ 5,813</u>
IRC §736(a) other payments, including unrealized receivables			
Other	0	0	0
Total	<u>\$ 54,047</u>	<u>\$ 96,569</u>	<u>\$ 42,522</u>

¹ Depreciation recapture is treated as an unrealized receivable. However, in a liquidation it is considered to be property, which like an installment sale, must be reported as ordinary income in the year of sale.

The calculation of total gain and determination of where the items are reported can be shown in **Table D**.

Situation 10, Table D
Calculation of Profit for Lisa in
Complete Liquidation of her LLC Interest

Liquidation payment, January 1, 20x2	\$ 50,236
Lisa's liabilities assumed	46,333
Amount realized	<u>\$96,569</u>
Lisa's basis	(54,047)
Lisa's total gain	<u>\$ 42,522</u>

If the LLC made a §754 election, you can use **Tables E and F** indicate the adjustments the LLC makes based on the same procedure as in **Situation 7, Tables D and E**.

Situation 10, Table E
Allocation of Basis of LLC Property Under IRC §743(b) for the LLC

	LLC Assets		Difference
	Adjusted Basis	FMV	
IRC §§1221 and 1231 property			
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500
Equipment & vehicle	14,565	21,600	7,035
Building	139,736	198,000	58,264
Land	5,000	11,500	6,500
Goodwill	4,167	<u>45,000</u>	<u>40,833</u>
Total	<u>\$163,968</u>	\$278,100	\$114,132
Other property			
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable	0	10,000	10,000
Bakery supplies	0	<u>400</u>	<u>400</u>
Total	<u>\$ 1,200</u>	\$11,600	\$10,400
Total assets	\$165,168	\$289,700	\$124,532

Situation 10, Table F
Calculation of Special Allocation After Liquidation
of Lisa's Interest by J & L Custom Cakes, LLC

	Difference between FMV and LLC Basis	Percent		Member Adjustment	Amount of Adjustment
Step 1					
A) Capital assets	\$114,132	91.65%	×	\$ 41,511	\$ 38,044
B) Other property	<u>10,400</u>	<u>8.35%</u>	×	41,511	<u>3,467</u>
Total adjustment	\$124,532	100.00%			\$ 41,511
Step 2					
A) IRC §§1221 and 1231 property					
Stock ABC Corp.	\$ 1,500	1.31%	×	\$ 38,044	\$ 500
Equipment & vehicle	7,035	6.16%	×	38,044	2,345
Building	58,264	51.05%	×	38,044	19,421
Land	6,500	5.70%	×	38,044	2,167
Goodwill	<u>40,833</u>	<u>35.78%</u>	×	38,044	<u>13,611</u>
Total adjustment	\$114,132	100.00%			\$ 38,044
B) Other property					
Accounts receivable	\$10,000	96.15%	×	\$ 3,467	\$ 3,333
Bakery supplies	<u>400</u>	<u>3.85%</u>	×	3,467	<u>133</u>
Total	\$10,400	100.00%			\$ 3,467
Total	\$124,532				\$ 41,511

The exception is that only §736(b) payments are allocated. Since §736(b) payments are made by the LLC, the basis adjustments are added directly to the balance sheet and can be shown in **Table G**. Or, they are maintained as a separate schedule to be allocated to the LLC in the same manner as the special allocation to Gabe as shown in **Situation 7**. Assume the LLC borrows \$50,000 to provide enough cash to make the payment to Lisa.

Situation 10, Table G
Balance Sheet Adjustments for Liquidation Payment
for Appreciated Inventory and IRC §754 Election

Assets	Opening Balance	+	Adjustments	=	Balance After Adjustments
Cash	\$ 1,200		For loan \$ 50,000 (50,236) ^a		\$ 964
Accounts receivable	\$ 0		\$ 3,333		\$ 3,333
Bakery supplies	0		133		133
Stock ABC Corp.	500		500		1,000
Equipment & vehicle	14,565		2,345		16,910
Building	139,736		19,421		159,157
Land	5,000		2,167		7,167
Goodwill	4,167		<u>13,611</u>		<u>17,778</u>
Total assets	<u>\$165,168</u>		<u>\$ 41,274</u>		<u>\$206,442</u>
Liabilities and capital					
Liabilities	\$139,000		Increase \$ 50,000		\$189,000
Capital	26,168		(50,236) ^b 41,510 ^c		(24,068) 41,510
Total	<u>\$165,168</u>		<u>\$ 41,274</u>		<u>\$206,442</u>

^a Liquidation payment.

^b Addition to basis.

^c Cash distribution to Lisa: net reduction in cash that reduces the total adjustment on the balance sheet from \$41,511 to \$41,274.

**SITUATION 11. COMPLETE WITHDRAWAL (LIQUIDATION)
OF A MEMBER WITH A SERIES OF FIXED PAYMENTS**

Instead of taking all the cash at once, Lisa and the LLC agree to a series of fixed payments from the LLC. In this situation, the two parties know the financial commitment in advance. The total payments are greater than in **Situation 10** to reflect the time value of money.

Lisa and the LLC agree on a series of 10 payments of \$10,000 each, with a down payment of an additional \$25,000.

First, use the basis of Lisa's LLC interest to allocate to her share of the assets, and show in shown in **Table A**.

**Situation 11, Table A
Allocation of Basis in J & L Custom Cakes, LLC to Lisa on January 1, 20x2**

John's basis = capital account	\$ 10,741	+	Share of liabilities	\$ 46,333	=	\$ 57,074
Lisa's basis = capital account	15,427	+	Share of liabilities	92,667	=	108,093
LLC Basis = capital account	\$ 26,168	+	Liabilities	\$139,000	=	\$165,168
	LLC Basis		John's Basis			Lisa's Basis
Total basis	\$165,168		\$ 57,074			\$108,093
less cash	(1,200)		(400)			(800)
Balance	\$163,968		\$ 56,674			\$107,293
Unrealized receivables and substantially appreciated inventory						
	LLC Basis		John's Basis			Lisa's Basis
Accounts receivable	\$ 0		\$ 0			\$ 0
Bakery supplies	0		0			0
Depreciation recapture	0		0			0
Subtotal UR & SAI	\$ 0		\$ 0			\$ 0
Adjusted basis for allocation	\$163,968		\$ 56,674			\$107,293
Stock ABC Corp.	\$ 500		\$ 195			\$ 327
Equipment & vehicle	14,565		4,855			9,710
Building	139,736		47,677			91,268
Land	5,000		1,789			3,266
Goodwill	4,167		2,158			2,722
Total	\$163,968		\$ 56,674			\$107,293

Complete **Table B** to show the reportable gain for property, which is allocated for §736(b) liquidation purposes.

Situation 11, Table B
Liquidation of Lisa's Remaining $\frac{1}{3}$ Interest in J & L Custom Cakes, LLC

Assets	Lisa's $\frac{2}{3}$ Share		Liquidation of Lisa's $\frac{1}{3}$ Share		Gain to Lisa	
	Adjusted Basis	FMV	Adjusted Basis	FMV		
Cash	\$ 800	\$ 800	\$ 400	\$ 400	\$ 0	
Accounts receivable	0	6,667	0	3,334	3,334	OI
Bakery supplies	0	267	0	134	134	OI
Stock ABC Corp.	327	1,333	164	667	503	CG
Equipment & vehicle	9,710	14,400	4,855	7,200	2,345	DR
Building	91,268	132,000	45,634	66,000	20,366	CG
Land	3,266	7,667	1,633	3,834	2,201	CG
Goodwill	<u>2,722</u>	<u>30,000</u>	<u>1,361</u>	<u>15,000</u>	<u>13,639</u>	CG
Total assets	\$108,093	\$193,134	\$54,047	\$96,569	\$42,522	
Liabilities and capital						
Liabilities	\$ 92,667	\$ 92,667	\$ 46,333	\$ 46,333		
Capital	<u>15,427</u>	<u>100,467</u>	<u>7,714</u>	<u>50,236</u>		
Total	\$108,093	\$193,134	\$54,047	\$96,569		

OI = ordinary income; CG = capital gain; DR = depreciation recapture

Use Table C to classify Lisa's liquidation payments.

Situation 11, Table C
Classification of Liquidation Payments for
Lisa on Liquidation of her LLC Interest

Type of Property	Adjusted Basis of Interest	FMV of Lisa's Interest ¹	Gain
IRC §736(b) payments for capital gain property			
Cash	\$ 400	\$ 400	\$ 0
Stock ABC Corp.	164	667	503
Equipment & vehicle	4,855	4,855	0
Building	45,634	66,000	20,366
Land	1,633	3,834	2,201
Goodwill	1,361	15,000	13,639
Total	<u>\$ 54,047</u>	<u>\$ 90,756</u>	<u>\$ 36,709</u>
IRC §736(b) payments for substantially appreciated inventory			
Accounts receivable	\$ 0	\$ 3,334	\$ 3,334
Bakery supplies	0	134	134
Depreciation recapture	0	2,345	2,345
Total	<u>\$ 0</u>	<u>\$ 5,813</u>	<u>\$ 5,813</u>
IRC §736(a) other payments, including unrealized receivables			
Other	0	74,764	74,764
Total	<u>\$ 54,047</u>	<u>\$ 171,333</u>	<u>\$ 117,286</u>

¹ Depreciation recapture is treated as an unrealized receivable. However, in a liquidation it is considered to be property, which like an installment sale, must be reported as ordinary income in the year of sale.

Complete **Table D** to show the calculation of gain for Lisa.

Situation 11, Table D
Calculation of Gain for Lisa for Fixed Liquidation Payments
(Fixed Liquidation Payments of \$10,000 for 10 Years)

Liquidation payments (10 × \$10,000) + \$25,000 down payment	\$125,000
Lisa's liabilities assumed by the LLC	46,333
Amount realized	<u>\$171,333</u>
Lisa's basis	(54,047)
Lisa's total gain	<u>\$117,286</u>
Payments received:	
20x2: cash distribution	\$ 35,000
20x2: liabilities assumed by LLC	46,333
Amount realized in 20x2	<u>\$ 81,333</u>

Use Table E to calculate the allocation of payments between various types of income. Remember that in year 1 Lisa must also report the debt which was assumed.

Each annual payment is split between IRC § 736(b) portion and IRC §736(a) portion by calculating the ratio of the total IRC §736 (b) payments to the total amount received.

$$\text{\$736(b)\%} = \frac{\text{Total \text{\$736(b) payments}}}{\text{Amount Realized}} = \frac{\text{\$96,569}}{\text{\$171,333}} = 56.363339\%$$

The 20x2 §736(b) payment is $56.363339\% \times \$81,333 = \$45,842$

The ordinary IRC §736(b) gain is reported first and then the IRC §736(b) basis which is \$40,029 (\$45,842 IRC §736(b) less \$5,813 ordinary gain). This reduces Lisa's basis from \$54,047 to \$14,018 to be recovered in a future year or years. If the first year payment is not sufficient to cover the ordinary gain, the additional ordinary gain is still reported and then added to basis for future year's recovery before capital gain.

20x2 IRC §736(b) payment	\$ 45,842
Less IRC §736(b) SAI (ordinary gain)	(5,813)
Balance	\$ 40,029
Basis in IRC §736(b) property	54,047
Basis left to recover	\$ 14,018

The 20x2 IRC §736(a) payment is \$35,491 or (\$81,333 – \$45,842).

The 20X3 payment of \$10,000 is \$5,636 IRC §736(b) fully used to reduce basis.

The IRC §736(a) is \$10,000 – \$5,636 or \$4,364.

The LLC reporting is as follows:

- The §736(b) cash payment is reported annually as a distribution on Schedule M, Form 1065.
- The LLC reports a guaranteed payment on Form 1065 equivalent to the §736(a) payment.
- If the LLC makes a §754 election, the LLC increases its basis each year in property by the annual §736(b) gain on property reported by Lisa. This is the same as **Situation 10, Tables E and F**.

Gain is reported by Lisa as follows:

- The §736(b) payment for capital gain property is reported on Lisa's Schedule D, Part II.
- The §736(b) payment for substantially appreciated inventory is reported on Lisa's Form 4797, Part II.
- The §736(a) payment is reported as a guaranteed payment on her Schedule K-1 and then Schedule E.

Table E is the liquidation schedule for the annual reporting of the liquidation payments made to Lisa. The first year is confusing because the liability assumption of \$46,333 must be reported in Year 1.

Lisa's beginning basis is \$54,047, which is reflected by a capital account of \$7,713 and share of liabilities of \$46,333. Since the §736(a) payment of \$35,491 exceeds the actual cash withdrawal of \$35,000, the difference is added to Lisa's beginning capital account. The ending capital account is verified by deducting the §736(b) basis reduction from Lisa's beginning basis (\$54,047 – \$40,029 = 14,018). Following is a summary of the annual reporting in **Table E**.

- Year 20x3** Ordinary gain of \$4,364 and no capital gain with an allocation.
- Year 4** No capital gain reported by Lisa and no step up in basis for the members.
- Year 5** \$2,891 of capital gain (\$5,636 of §736(b) payment – \$2,745 remaining basis).
- Year 6–11** \$5,636 of capital gain reported by Lisa allocated annually by the LLC.

Situation 11, Table E

Liquidation Schedule for Fixed Payments Made to Lisa by J & L Custom Cakes, LLC

Year	Payment	736(a)	736(b)	Lisa's Beginning Capital	Basis Change	Lisa's Ending Capital	Capital Gain
20x2	\$ 35,000 46,333	\$ 35,491	\$ 5,813 OI 40,029	\$ 7,713	\$ 491	\$ 14,017	
20x3	10,000	4,364	5,636	14,017	(5,636)	8,381	
20x4	10,000	4,364	5,636	8,381	(5,636)	2,745	
20x5	10,000	4,364	5,636	2,745	(2,745)	0	\$ 2,891
20x6	10,000	4,364	5,636	0	0	0	5,636
20x7	10,000	4,364	5,636	0	0	0	5,636
20x8	10,000	4,364	5,636	0	0	0	5,636
20x9	10,000	4,364	5,636	0	0	0	5,636
20x10	10,000	4,364	5,636	0	0	0	5,636
20x11	10,000	4,364	5,636	0	0	0	5,636
Total	\$171,333	\$74,767	\$96,566				\$36,707

If the LLC makes a §754 election, it can step up its basis in its assets as in **Situation 10**. However, since payments are being made over a period of time, the adjustments can only be made in the year of, and to the extent of, the gain reported by Lisa. This means a separate adjustment is made each year taxable gain is reported by Lisa.

Complete Tables F, G, and H to show this allocation.

Situation 11, Table F
Allocation of Basis of LLC Property Under IRC §743(b) for the LLC

	LLC Assets		Difference
	Adjusted Basis	FMV	
IRC §§1221 and 1231 property			
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500
Equipment & vehicle	14,565	21,600	7,035
Building	139,736	198,000	58,264
Land	5,000	11,500	6,500
Goodwill	4,167	45,000	40,833
Total	\$163,968	\$278,100	\$114,132
Other property			
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable	0	10,000	10,000
Bakery supplies	0	400	400
Total	\$ 1,200	\$ 11,600	\$ 10,400
Total assets	\$165,168	\$289,700	\$124,532

Situation 11, Table G
Calculation of Special Allocation After Liquidation
of LLC Interest by J & L Custom Cakes, LLC

	Difference between FMV and LLC Basis	Percent		Member Adjustment	Amount of Adjustment
Step 1					
A) Capital assets	\$114,132	91.65%	×	\$ 2,891	\$ 2,650
B) Other property	<u>10,400</u>	<u>8.35%</u>	×	2,891 ^a	<u>241</u>
Total adjustment	\$124,532	100.00%			\$ 2,891
Step 2					
A) IRC §§1221 and 1231 property					
Stock ABC Corp.	\$ 1,500	1.31%	×	\$ 2,650	\$ 35
Equipment & vehicle	7,035	6.16%	×	2,650	163
Building	58,264	51.05%	×	2,650	1,353
Land	6,500	5.70%	×	2,650	151
Goodwill	<u>40,833</u>	<u>35.78%</u>	×	2,650	<u>948</u>
Total adjustment	\$114,132	100.00%			\$ 2,650
B) Other property					
Accounts receivable	\$ 10,000	96.15%	×	\$ 241	\$ 232
Bakery supplies	<u>400</u>	<u>3.85%</u>	×	241	<u>9</u>
Total	\$ 10,400	100.00%			\$ 241
Total	\$124,532				\$ 2,891

^a The adjustment equals the gain reported by Lisa on the IRC §736(b) payments in year 20x5 of \$2,891.

The above adjustments are allocated to the LLC balance sheet in year 20x5.

Situation 11, Table H
Balance Sheet Adjustments for Liquidation Payment
for Appreciated Inventory and IRC §754 Election

Assets	Opening Balance	+	Adjustments	=	Balance After Adjustments
Cash	\$ 1,200		\$ 0		\$ 1,200
Accounts receivable	0		232		232
Bakery supplies	0		9		9
Stock ABC Corp.	500		35		535
Equipment & vehicle	14,565		163		14,728
Building	139,736		1,353		141,089
Land	5,000		151		5,151
Goodwill	<u>4,167</u>		<u>948</u>		<u>5,115</u>
Total assets	\$165,168		\$ 2,891		\$168,059
Liabilities and capital					
Liabilities	\$139,000		\$ 0		\$139,000
Capital	<u>26,168</u>		<u>2,891</u>		<u>29,059</u>
Total	165,168		2,891		\$168,059

SITUATION 12. COMPLETE WITHDRAWAL (LIQUIDATION) OF A MEMBER
WITH A SERIES OF PAYMENTS NOT FIXED IN ADVANCE

The calculation of the amount realized cannot be determined in advance. Therefore, there is no split of each annual payment as in Situation 11. Instead, the order of tax reporting is:

1. §736(b) depreciation recapture
2. §736(b) ordinary gain for substantially appreciated inventory
3. §736(b) recovery of basis
4. §736(b) capital gain

The balance is all §736(a) payments.

Lisa and the LLC choose variable payments which are 20% of the net income per year for 10 years. In Year 1, the net profit is \$60,000.

Use the following table to determine the basis reduction in the first year.

20x1 Payment received (cash)	\$ 12,000
Liabilities assumed	<u>46,333</u>
Amount realized	\$ 58,333
First allocation to recapture	<u>(2,345)</u>
Balance	\$ 55,988
Recovery of IRC §736(b) ordinary gain	<u>(3,468)</u>
Balance reduces basis	\$ 52,520

SITUATION 13. TERMINATION OF THE LLC

Lisa, in J & L Custom Cakes, LLC, to which Gabe had been added on January 1, 20x1, dies on June 30, 20x1. The remaining members are John and Gabe. They feel they cannot purchase Lisa's interest and therefore decide to terminate the business. Lisa's estate receives a step-up in basis on her share of LLC assets as of June 30. The accounts receivable do not receive a step-up in basis because they are an IRD item in addition to Lisa's share of LLC net income to June 30.

After six months of operation, the LLC balance sheet is the same as at the time Gabe purchased his interest. Complete Table A to show the FMV of Lisa's interest in the LLC and her basis of the assets in the estate.

Situation 13, Table A
Basis for Lisa's Estate in J & L Custom Cakes, LLC

Assets	FMV of Lisa's LLC Interest	Basis for Lisa's Estate
Cash	\$ 400	\$ 400
Accounts receivable	3,334	0
Bakery supplies	134	134
Stock ABC Corp.	667	667
Equipment & vehicle	7,200	7,200
Building	66,000	66,000
Land	3,834	3,834
Goodwill	<u>15,000</u>	<u>15,000</u>
Total assets	\$96,569	\$93,235
Liabilities and capital		
Liabilities	\$46,333	\$46,333
Capital	<u>50,236</u>	<u>46,902</u>
Total	\$96,569	\$93,235

Complete Tables B and C to show the adjustments to be made for Lisa's estate's interest.

Situation 13, Table D
Allocation of Basis of LLC Property under IRC §743(b) for Lisa's Estate

	LLC Assets		
	Adjusted Basis	FMV	Difference
IRC §§1221 and 1231 property			
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500
Equipment & vehicle	14,565	21,600	7,035
Building	139,736	198,000	58,264
Land	5,000	11,500	6,500
Goodwill	4,167	45,000	40,833
Total	\$163,968	\$278,100	\$114,132
Other property			
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable ^a	0	0	0
Bakery supplies	0	400	400
Total	\$ 1,200	\$ 1,600	\$ 400
Total assets	\$165,168	\$279,700	\$114,532

^aSince the accounts receivable is an "income in respect of decedent" item and will not receive a step-up in basis, it is not included in the allocation process.

Situation 13, Table C
Calculation of Special Allocation for Lisa's Estate

	Difference between FMV and LLC Basis	Percent		Member Adjustment	Amount of Adjustment
Step 1					
A) Capital assets	\$114,132	99.65%	×	\$ 38,177	\$ 38,044
B) Other property	400	0.35%	×	38,177	133
Total adjustment	\$114,532	100.00%			\$ 38,177
Step 2					
A) IRC §§1221 and 1231 property					
Stock ABC Corp.	\$ 1,500	1.31%	×	\$ 38,044	\$ 500
Equipment & vehicle	7,035	6.16%	×	38,044	2,345
Building	58,264	51.05%	×	38,044	19,421
Land	6,500	5.70%	×	38,044	2,167
Goodwill	40,833	35.78%	×	38,044	13,611
Total adjustment	\$114,132	100.00%			\$ 38,044
B) Other property					
Accounts receivable	\$ 0	0.00%	×	\$ 133	\$ 0
Bakery supplies	400	100.00%	×	133	133
Total	\$ 400	100.00%			\$ 133
Total	\$114,532				\$ 38,177

The adjusted items are specially allocated to Lisa's estate as the assets are sold. Complete **Table D** to illustrate the potential gain.

Situation 13, Table D
Gain for Lisa's Estate on Sale of J & L Custom Cakes, LLC Assets

Assets	LLCFMV	LLC Basis	LLC Gain	Lisa's Estate Share	Lisa's Estate Special Basis	Gain for Estate
Cash	\$ 1,200	\$ 1,200	\$ 0	\$ 0	\$ 0	\$ 0
Accounts receivable	10,000	0	10,000	3,333	0	3,333
Bakery supplies	400	0	400	133	133	0
Stock ABC Corp.	2,000	500	1,500	500	500	0
Equipment & vehicle	21,600	14,565	7,035	2,345	2,345	0
Building	198,000	139,736	58,264	19,421	19,421	0
Land	11,500	5,000	6,500	2,167	2,167	0
Goodwill	45,000	4,167	40,833	13,611	13,611	0
Total assets	<u>\$289,700</u>	<u>\$165,168</u>	<u>\$124,532</u>	<u>\$41,510</u>	<u>\$ 38,177</u>	<u>\$ 3,333</u>

SITUATION 14. SUCCESSOR IN INTEREST CONTINUES IN LLC

Use the same facts as **Situation 13**. Lisa's widower continues to participate in the LLC, assuming Lisa's LLC interest after death as her successor in interest.

The LLC year closes for Lisa on June 30. Her net earnings for the first half of the year are allocated to her final return. The net earnings for the last half of the year are allocated to the successor in interest. As of July 1, the successor in interest receives a step-up in basis of his LLC interest except for the IRD items which are allocated to him as a normal part of the LLC operations. If a §754 election was made, or is made with the 20x2 LLC return, he has a step-up in basis of LLC assets as in **Situation 13, Tables A, B and C**. The application of the special basis adjustment establishes a special depreciation account for the depreciable assets and a special holding account for the IRD items.

There is no depreciation recapture or gain on inventory items except to the degree sales exceed his share of inventory declared at death. The basis for Lisa's successor in interest begins at its FMV on July 1, 20x1, less IRD items, or \$93,233 plus a special basis addition of \$38,177. The LLC balance sheet remains unchanged and continues to carry Lisa's old capital account of \$54,047 as adjusted.

In the year of death, two Schedules K-1 are prepared allocating a portion of the LLC interest to Lisa for the first half of the year and a portion to her widower, estate, or successor in interest for the second half.

SITUATION 15. SALE OF A DECEASED MEMBER'S INTEREST

Use the same facts as **Situation 13**. John and Gabe carry life insurance on Lisa under a **cross-purchase arrangement** where John and Gabe receive the insurance proceeds and use it to buy Lisa's LLC interest from the estate or her successor in interest.

For the estate, the reporting is the same as **Situation 13**. The LLC allocates on a Schedule K-1 any IRD items to the estate. IRD is the first half-year share of net income and accounts receivable. If the LLC made or makes a §754 election in its 20x2 return, the LLC makes the same basis adjustment to Lisa's estate as in **Situation 13, Tables A, B and C** if the estate continues in the LLC for a time before the buyout. However, if the buyout is immediate, the FMV and allocation of basis in **Situation 13, Table A** are sufficient. There is no depreciation recapture or ordinary income on the sale of the LLC assets to John and Gabe other than the IRD items.

John and Gabe have a new basis in this share of the LLC interest they purchase from the estate. The basis equals the purchase price. The purchase price is as follows:

$$\text{\$50,236 (price paid)} + \text{\$46,333 (debts assumed)} = \text{\$96,569.}$$

However, since a greater than 50% interest in the LLC is transferred within a 12-month period, the LLC is terminated (assuming TCJA goes out of the law after the 2025 tax year).

The procedure is the same as in **Situation 8**, where John and Gabe purchase Lisa's interest directly. For John, the first step is to allocate the outside basis of his share of the LLC basis and then the special allocation for the share purchased as in **Situation 8, Table I**. For Gabe, the starting point is his $\frac{1}{3}$ share of the common LLC basis ($\frac{1}{3}$ of \$165,168) plus his special basis adjustment from **Situation 7, Table E**. This is added to his share of the LLC basis of his purchase of the $\frac{1}{2}$ of Lisa's estate's remaining interest plus the same special allocation for this purchase as John (**Situation 8, Table H**). The bases for John and Gabe are combined in **Table C** to show the total bases available for deductions. Part of the deductions will be taken on the LLC books and part will be a special allocation taken separately on the members Schedules K-1.

Complete Tables A, B, and C.

Situation 15, Table A
Adjusted Basis for John on his $\frac{1}{2}$ Share of J & L Custom Cakes, LLC Assets

Assets	Basis of John's $\frac{1}{3}$ Interest	Purchased 16.7% Basis	Special Allocation	John's New Basis
Cash	\$ 400	\$ 200	\$ 0	\$ 600
Accounts receivable	0	0	1,667	1,667
Bakery supplies	0	0	67	67
Stock ABC Corp.	195	83	250	528
Equipment & vehicle	4,855	2,428	1,172	8,455
Building	47,677	23,289	9,711	80,677
Land	1,789	833	1,084	3,706
Goodwill	<u>2,158</u>	<u>695</u>	<u>6,805</u>	<u>9,658</u>
Total	\$ 57,074	\$ 27,528	\$ 20,756	\$105,358

Situation 15, Table B
Re-Combination of Gabe's Basis in Two Separate Purchases of
Part of Lisa's Interest in J & L Custom Cakes, LLC

Assets	Gabe's 1/3 of LLC Basis	Gabe's Adjust for 1/3 Interest	Gabe's Purchase 16.7% of LLC Basis	Adjustment for 16.7%	Gabe's Total Basis
Cash	\$ 400	\$ 0	\$ 200	\$ 0	\$ 600
Accounts receivable	0	3,333	0	1,667	5,000
Bakery supplies	0	133	0	67	200
Stock ABC Corp.	167	500	83	250	1,000
Equipment & vehicle	4,855	2,345	2,428	1,172	10,800
Building	46,579	19,421	23,289	9,711	99,000
Land	1,667	2,167	833	1,084	5,751
Goodwill	<u>1,389</u>	<u>13,611</u>	<u>695</u>	<u>6,805</u>	<u>22,500</u>
Total	\$ 55,057	\$ 41,511	\$ 27,528	\$ 20,755	\$144,851

Situation 15, Table C
Combination of John's and Gabe's Basis in J & L Custom Cakes, LLC
to Show the Total Basis Available for John and Gabe

Assets	John's Basis	Gabe's Basis	Total Basis
Cash	\$ 600	\$ 600	\$ 1,200
Accounts receivable	1,667	5,000	6,667
Bakery supplies	67	200	267
Stock ABC Corp.	528	1,000	1,528
Equipment & vehicle	8,455	10,800	19,255
Building	80,677	99,000	179,677
Land	3,706	5,751	9,457
Goodwill	<u>9,658</u>	<u>22,500</u>	<u>32,158</u>
Total	\$105,358	\$144,851	\$250,209

SITUATION 16. LLC PURCHASES DECEASED MEMBER'S INTEREST

Use the same facts as **Situation 13**. J & L Custom Cakes LLC carried a \$100,000 insurance policy on Lisa, payable to the LLC with a binding agreement that the surviving members are to use the proceeds to purchase the deceased member's LLC interest.

The FMV of Lisa's estate's LLC interest is \$96,569. This is composed of \$50,236 of equity and \$46,333 of assumed debt. The liquidation payment for Lisa's estate's LLC interest is \$50,236.

Liquidation payment July 1, 20x1	\$50,236
Lisa's liabilities assumed	46,333
Amount realized	<u>\$96,569</u>
Lisa's estate's basis (from situation 13A)	<u>(93,235)</u>
Gain	\$ 3,334

The \$96,569 amount received is a §736(b) payment for property with no gain to be reported. The \$3,334 of gain is a §736(a) payment reported by the LLC on a Schedule K-1 as a guaranteed payment. \$46,902 is reported by the LLC as a withdrawal by Lisa's estate (\$50,236 total payments – \$3,334 guaranteed payment).

For the estate, the reporting is similar to **Situation 10**. The LLC allocates on a Schedule K-1 the two IRD items to the estate. IRD is the first half-year share of net income and accounts receivable. The LLC is not terminated in a liquidation distribution in contrast to the sale to John and Gabe in **Situation 15**. The gain in **Table 16A**, except the \$3,334 accounts receivable (an IRD), are offset by the step up in basis shown in **Table 13A**.

If the LLC made, or makes a §754 election in its 20x2 return, it receives a special basis adjustment similar to the §736(b) step-up in basis shown in **Situation 10, Tables F and G**. These calculations are shown in **Situation 16, Tables B and C**. The special adjustment is the difference between Lisa's remaining LLC basis (\$54,046) and the FMV of the assets which receive a stepped-up basis (\$93,235). This special basis adjustment is \$39,189. The application of the special basis adjustment is to establish a special depreciation account for the depreciable assets, a holding account for the land, and a special holding account for ordinary income items to be allocated when they are sold or used.

Situation 16, Table A
Classification of Liquidation Payments for
Lisa on Liquidation of her LLC Interest

Type of Property	Adjusted Basis of Lisa's Interest	FMV of Lisa's Interest	Gain
IRC §736(b) payments for capital gain property			
Cash	\$ 400	\$ 400	\$ 0
Stock ABC Corp.	164	667	503
Equipment & vehicle	4,855	4,855	0
Building	45,634	66,000	20,366
Land	1,633	3,834	2,201
Goodwill	1,361	15,000	13,639
Total	<u>\$ 54,047</u>	<u>\$ 90,756</u>	<u>\$ 36,709</u>
IRC §736(b) payments for substantially appreciated inventory			
Accounts receivable	\$ 0	\$ 3,334	\$ 3,334
Bakery supplies	0	134	134
Depreciation recapture ^a	0	2,345	2,345
Total	<u>\$ 0</u>	<u>\$ 5,813</u>	<u>\$ 5,813</u>
IRC §736(a) other payments, including unrealized receivables			
Other	0	0	0
Total	<u>\$ 54,047</u>	<u>\$ 96,569</u>	<u>\$ 42,522</u>

^a Depreciation recapture is treated as an unrealized receivable but in a liquidation is considered to be property, which like an installment sale, must be reported as ordinary income in the year of sale.

Situation 16, Table B
Allocation of Basis of LLC Property Under IRC §743(b) for
J & L Custom Cakes, LLC's Purchase from Lisa's Estate

	LLC Assets		Difference
	Adjusted Basis	FMV	
IRC §§1221 and 1231 property			
Stock ABC Corp.	\$ 500	\$ 2,000	\$ 1,500
Equipment & vehicle	14,565	21,600	7,035
Building	139,736	198,000	58,264
Land	5,000	11,500	6,500
Goodwill	<u>4,167</u>	<u>45,000</u>	<u>40,833</u>
Total	\$163,968	\$278,100	\$114,132
Other property			
Cash	\$ 1,200	\$ 1,200	\$ 0
Accounts receivable	0	0	0
Office supplies	<u>0</u>	<u>400</u>	<u>400</u>
Total	\$ 1,200	\$ 1,600	\$ 400
Total assets	\$165,168	\$279,700	\$114,532

Situation 16, Table C
Calculation of Special Allocation for J & L Custom
Cakes, LLC after Liquidation of Lisa's Estate LLC Interest

	Difference between FMV and LLC Basis	Percent	Member Adjustment	Amount of Adjustment
Step 1				
A) Capital assets	\$114,132	99.65% ×	\$ 39,188 ^a	\$ 39,051
B) Other property	<u>400</u>	<u>0.35%</u> ×	39,188	<u>137</u>
Total adjustment	\$114,532	100.00%		\$39,188
Step 2				
A) IRC §§1221 and 1231 property				
Stock ABC Corp.	\$ 1,500	1.31% ×	\$ 39,051	\$ 511
Equipment & vehicle	7,035	6.16% ×	39,051	2,406
Building	58,264	51.05% ×	39,051	19,936
Land	6,500	5.70% ×	39,051	2,226
Goodwill	<u>40,833</u>	<u>35.78%</u> ×	39,051	<u>13,972</u>
Total adjustment	\$114,132	100.00%		\$ 39,051
B) Other property				
Accounts receivable	\$ 0	0.00% ×	\$ 137	\$ 0
Bakery supplies	<u>400</u>	<u>100.00%</u> ×	137	<u>137</u>
Total	\$ 400	100.00%		\$ 137
Total	\$114,532			\$ 39,188

^a The adjustment equals the difference between Lisa's estate's outside basis of \$93,235 and Lisa's basis of her LLC interest of \$54,047.

Situation 16, Table D

IRC §754 Balance Sheet Adjustments for Liquidation Payment for Liquidation of Lisa's Estate

Assets	Opening Balance	+	Adjustments	=	Balance After Adjustments
Cash	\$ 1,200		Insurance \$100,000 (50,236) ^a		\$ 50,964
Accounts receivable	0		0		0
Bakery supplies	0		118		118
Stock ABC Corp.	500		513		1,013
Equipment & vehicle	14,565		2,408		16,973
Building	139,736		19,946		159,682
Land	5,000		2,225		7,225
Goodwill	4,167		13,978		18,145
Total assets	\$165,168		\$ 88,952		\$254,120
Liabilities and capital					
Liabilities	\$139,000		\$ 0		\$139,000
Capital	26,168		Insurance 100,000 (50,236) ^b 39,188 ^c		115,120
Total	\$165,168		\$ 88,952		\$254,120

^a Liquidation payment.

^b Addition to basis.

^c Cash distribution to Lisa: net increase in cash that reduces the total adjustment on the balance sheet from \$89,953 to \$39,188.

Notes: